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SUBJECT: Prime Minister's Economic Advisor on the Greek Economy & GoG's Reform Capacity

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CLASSIFIED BY: Deborah A. McCarthy, DCM; REASON: 1.4(B), (D)

SUMMARY

¶1. (C) In a frank conversation with A/EconCouns, the Prime Minister's Economic Advisor, Apostolis Philippopoulos, recently discussed his views on the impact of the financial crisis on the Greek economy, Greek economic policy in response to the crisis, and the government's capacity to take on tough structural reforms in the current political climate. Philippopoulos, an economics professor who has served in his current capacity since December 2008, openly admitted that the current economic situation, with persistent budget deficits, ballooning debt and eroding external competitiveness, is unsustainable. He indicated that the Prime Minister and his key economic advisors know what key reforms are needed (namely liberalizing labor and product markets, controlling tax evasion, and minimizing the size of the public sector). He holds little hope, however, that real reforms will be implemented in the next few months. Philippopoulos believes the GoG missed a crucial opportunity to implement reforms during the 2004-2005 time period - a time when the political and economic environment in Greece was more conducive to change. Today, he lamented, Greek politics has become too polarized, and Greek society lacks the social cohesion necessary to undertake reforms that will fundamentally and indelibly alter the relationship between government and citizen.

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IMPACT OF THE CRISIS ON THE GREEK ECONOMY & GOG RESPONSE

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¶2. (C) Philippopoulos claimed that while the financial crisis has affected the Greek economy, thus far the impact has been mild relative to other EU and Eurozone countries. He believes the reasons for this are two-fold: (1) the Greek banking system was not exposed to toxic assets, as was the case in the U.S. and other

European countries; and (2) the GoG's economic policy in response to the initial phases of the crisis was cautious. Philippopoulos praised the GoG for abiding by the European Commission's (EC) recommendation in late 2008 to avoid a large fiscal stimulus package due to Greece's persistent budget deficits (3.7 percent of GDP in 2007 and 5 percent of GDP in 2008). He feels this was a very productive recommendation for Greece, since the multiplier effect (the Keynesian notion that every dollar of public spending acts as a stimulus to the economy by adding more than one dollar to GDP) is lower than 1:1 due to the "gross inefficiency" of the public sector and a highly politicized political system that allocates resources according to patronage and corruption rather than merit and efficiency. As a result, while the fiscal deficit and public debt have increased (most economic analysts forecast Greece's deficit will increase to 6-8 percent of GDP in 2009; the IMF forecasts debt to balloon to 109 percent of GDP in 2009), they would have been much higher if Greece had responded with a large stimulus package, as many in the government and the public desired.

¶3. (C) Instead, Philippopoulos explained, the GoG's economic policy in the face of the crisis has focused on restoring stability to the financial system through a EUR28 billion bank aid package (see reftel F) and a mild fiscal stimulus to support the most vulnerable (see reftel A). He also pointed to four rounds of budget measures the GoG has implemented in order to shrink the budget deficit to the government's target of 3.7 percent of GDP in 2009 (see reftel

A; the fourth round was announced in June with the goal of increasing revenues by EUR1.8 billion). [Note: While he stood by the GoG's official line on the 3.7 percent deficit, Philippopoulos seemed to squirm in his seat when discussing the GoG's target, repeatedly stating that he was trying to be objective. It was clear to A/EconCouns that he was trying to balance objectivity as a serious economist with allegiance to the PM, but in essence was saying that meeting this target was highly improbable. End Note.] Philippopoulos noted that he is worried about unemployment. As a lagging indicator, it is bound to increase, possibly by 10-11 percent by the end of the year (it already increased to 8.5 percent year/year in May, up from 6.6 percent at this time last year).

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ECONOMY NEEDS DEEP REFORMS

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¶4. (C) While praising the GoG's cautious economic policy, Philippopoulos openly admitted that the economy was in crisis and that the current situation was unsustainable. He said the measures taken by the GoG thus far have been of one-off and temporary nature and have had little impact thus far. The GoG has not undertaken measures aimed at truly transforming the structure of the Greek economy. At over 40 percent of GDP, he believes government expenditure is too high, and that the size of the public sector needs to be cut. While the size of the public sector and the shadow economy (i.e., unreported income, which is estimated to be 25 percent of GDP) are acting as auto stabilizers during Greece's economic downturn, Philippopoulos argued both are very bad in the long run, as they crowd out the private sector, deprive the government of crucial revenues, and stunt prospects for growth. He would like to see Greece develop a new engine of growth, less reliant on consumer spending and government budget deficits as in the past decade and more driven by investments and savings.

¶5. (C) In addition, Philippopoulos believes the GoG should focus on reforms that will reverse the decline in Greece's competitiveness. These include liberalizing labor and product markets from excessive regulation, implementing a regulation that would make the public sector more accountable and more efficient, and developing a new

incomes policy for the public sector. He noted that public sector wages are the key determinants of wage growth in Greece, and Greece has lost competitiveness because wage growth has outpaced productivity growth.

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. . . BUT GREECE LACKS SOCIAL COHESION TO SUPPORT REFORMS

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¶6. (C) Unfortunately, Philippopoulos does not see reforms of this magnitude on the horizon. Instead, he sees the GoG taking further stop-gap measures that will do little to transform the economy, thereby having only marginal impact on Greece's economic problems. He believes the GoG will announce further one-off and temporary measures this fall (some as early as September 5, when the Prime Minister makes a major speech at the Thessaloniki Trade Fair), including another public sector wage freeze for 2010 and various revisions to the taxation system aimed at decreasing the incidence of tax evasion. The economic reforms that Greece needs require social cohesion, a strong leader and public support, according to Philippopoulos. While he quickly added that Prime Minister Karamanlis is a strong leader, he believes that the Greek political system has become far too polarized for anyone to unite the public behind reforms that will fundamentally and indelibly alter the relationship between government and citizen. Selling the public on these reforms requires not only someone that can articulate the necessity of change, but also a system with a bit less "noise" and populism.

¶7. (C) Philippopoulos stated that the governing New Democracy party missed a crucial opportunity in 2004-2005 to implement deep reforms. This was a key time period when the opposition was weak, trade unions were relatively quiet, and thanks to the euphoria engendered by the Olympics, the Greek population was united in an unprecedented manner. He argued that people - even public sector employees - would have listened and supported reforms then. Sighing wistfully, he admitted this is not the case today.

COMMENT

¶8. (C) Despite being an economic advisor to the Prime Minister, it is not clear how much direct access Philippopoulos has to the PM, or how strong his influence is on economic policy decision-making. What is clear from the meeting, however, is his concern over the lack of meaningful economic reforms taken thus far and the state of affairs in Greek politics. Karamanlis's speech on September 5 at the Thessaloniki Trade Fair will be telling whether he will continue to rely on stop-gap measures for fear of completely alienating public opinion in order to shore up Greece's public finances, or whether he might risk significant structural reforms with an eye both towards his legacy and the chance that Greek voters may forgive short-term economic pain for the sake of bold leadership.
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